DEPARTMENT OF STATE REVENUE

01-20200324.SLOF
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Supplemental Letter of Findings: 01-20200324; 01-20200325
Individual Indiana Income Tax
For the Years 2015 and 2016

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Supplemental Letter of Findings.

HOLDING

The Department disagreed with Indiana Shareholders that they met their burden of establishing that their businesses conducted qualifying research activities sufficient to generate income tax credits which flowed through to the Shareholders; the Department found that the businesses failed to establish that they undertook a process of qualifying experimentation which led to the discovery of technological innovations; the Department also concluded the Shareholders failed to provide specific, contemporaneous documentation of the businesses' qualifying labor expenses.

ISSUE

I. Indiana Individual Income Tax - Qualified Research Expense Projects and Documentation Needed to Verify the Credits Claimed.

Authority: IC § 6-3.1-4-1; IC § 6-8.1-5-1(c); IC § 6-8.1-5-4; *IDOPCP, Inc. v. Comm'r*, 503 U.S. 79 (1992); *Trinity Industries, Inc. v. U.S.*, 757 F.3d 400 (5th Cir. 2014); *Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96 (Ind. Ct. App. 1974); *Union Carbide Corp. and Subsidiaries, v. C.I.R.*, 97 T.C.M. 1207 (2009); I.R.C. § 41(d); Treas. Reg. § 1.41-4(a)(3)(i); Treas. Reg. § 1.41-4(d); Treas. Reg. § 1.6001-1; Letter of Findings, 01-20181626; 01-20181627; 01-20181628 (August 26, 2020).

Taxpayers argue that their companies conducted qualified, experimental research activities, that they can adequately document the wage expenses related to those projects, and that they are therefore entitled to claim the benefit of the flow-through credits attributed to their companies' qualifying research activities.

STATEMENT OF FACTS

Taxpayers are individual shareholder/owners of three Indiana companies which are in the business of fabricating various products. The companies fabricate medical devices, medical implants, plastic injection molds, and metal work platforms. The plastic injection molds are used by the companies' customers for producing automobile parts and various metal components.

The companies employ waterjet, plasma, and laser technology in producing the medical devices and injection molds. The companies' production of medical devices, injection molds, and platforms includes metal cutting, bending, welding, assembly, and 3D printing.

The companies claimed the RECs based on the results of a third-party consultant's REC study. The Department concluded that the companies failed to establish that their companies' development and manufacturing activities constituted "qualified research" and the companies failed to establish that the labor expenses - on which the credits were based - directly related to the claimed qualifying activities. In reviewing the labor expenses, the Department concluded that the companies' "time tracking" records did not represent the actual amount of time spent by company employees on qualified research and could not be used to factually support the Qualified Research Expenses ("QREs").

The Department's audit disallowed the companies' claimed credits. The audit found that "[n]o credits [were] available for pass-thru to the shareholders for [2015 and 2016]." The credit disallowance resulted in an assessment to the shareholder/owners of additional Indiana income tax. Those shareholder/owners (here "Taxpayers") disagreed with the Department's assessments and submitted a protest to that effect. An

administrative hearing was conducted during which Taxpayers' representative explained the basis for the protest. Letter of Findings 01-20191394; 01-20191412 (February 25, 2020), 20200429-IR-045200211NRA, was issued denying Taxpayers' protest on the ground that the Taxpayers failed to establish that their companies undertook a process of qualifying experimentation which led to the discovery of technological innovations and also because Taxpayers failed to provide specific, contemporaneous documentation of their businesses' qualifying labor expenses.

Taxpayers disagreed with the conclusions contained within the February Letter of Findings ("February LOF") and requested a rehearing. The Department granted the rehearing, and a second administrative hearing was conducted during which Taxpayers' representatives again explained the basis for their objections. This Supplemental Letter of Findings results.

I. Indiana Individual Income Tax - Qualified Research Expense Projects and Documentation Needed to Verify the Credits Claimed.

DISCUSSION

The issue is whether Taxpayers have now established that their companies conducted qualifying research activities and whether the companies can document the extent to which the companies conducted those qualifying activities.

A. Summary of Department's Audit Examination.

A detailed discussion of the Department's original audit analysis is set out in the February LOF. Briefly stated, the audit concluded that Taxpayers failed to establish that its expenses were incurred in the research and development of individual components, that Taxpayers relied entirely on the results of its unsubstantiated "research and expense study," and that the businesses failed to establish that they had engaged in a detailed "process of experimentation."

The audit found that, given the lack of documentation, under either the "uncertainty" or "discovery" standard, Taxpayers had failed to establish that Taxpayers spent money on qualifying research projects.

In addition, the Department's audit held that Taxpayers failed to maintain and retain contemporaneous documentation necessary to verify the expenses claimed. As explained in the February Letter of Findings:

> Taxpayers' businesses were unable to provide the requisite contemporaneous records establishing that they were entitled to claim the credits. Further, the businesses failed to meet Indiana's own general record keeping requirement, IC § 6-8.1-5-4(a), that they "keep books and records . . ." sufficient to determine the amount of tax owed by the businesses.

B. February LOF Summary.

The February LOF noted that Taxpayers had the statutory burden, under IC § 6-8.1-5-1(c), of establishing that the Department's assessment was wrong. Similarly, the LOF also noted that Taxpayers were to demonstrate their claim to the credit by clear and sufficient evidence that is within the exact letter of the law." *Indiana Dep't. of State Revenue, Sales Tax Division v. RCA Corp.*, 310 N.E.2d 96, 100-01 (Ind. Ct. App. 1974).

The LOF held that Taxpayers failed to establish that they were conducting qualified research because:

> Taxpayers can point to nothing its businesses have done to discover and develop a "new or improved business component" incorporated into or necessary to the production of the businesses' products.

. . . .

> [Taxpayers failed to] establish[] its businesses activities fundamentally expanded upon the "common knowledge" using variations of long-standing techniques or expanded the "existing level of information in [Taxpayer's] field of science or engineering."

In addition, the LOF held that - even if the businesses were conducting qualifying activities - they had no means to verify the extent and cost of those activities. The LOF rejected Taxpayers' estimates and pointed out that Taxpayers were required "to maintain and produce to the Department contemporaneous records sufficient to

verify the credits which they claim . . . ."

C. Taxpayers' Rehearing Arguments and Indiana's Legal Standard.

Taxpayers restate and reexplain their arguments that they are entitled to the originally claimed credits.

Taxpayers' various businesses fabricate medical devices such as orthopedic implants, manufacture molds in the production of plastic parts, and build metal workplace platforms.

In each instance, the businesses conducted "modeling and simulations," constructing prototype devices, and that Taxpayers state that they can fully substantiate the complexities and numerous steps which are required before a final product is delivered to one of its customers. For example, Taxpayers state that their medical business "develops a manufacturing process it believes encapsulates the appropriate operations and sequence [each time] it produces a prototype through that process."

In developing metal work stands, Taxpayers explains it must take steps "[i]n order to develop and fabricate the steel componentry the client requested" including identifying "locations of extant machinery and componentry, [and] access points to that machinery and componentry . . . ."

1. Qualifying Research Projects and the Four-Part I.R.C. § 41(d) Test.

IC § 6-3.1-4-1 (effective January 1, 2016) provides in part:

> "Indiana qualified research expense" means qualified research expense that is incurred for research conducted in Indiana. "Qualified research expense" means qualified research expense (as defined in Section 41(b) of the Internal Revenue Code).

IC § 6-3.1-4-1 (effective to December 31, 2015) provides in part:

> "Indiana qualified research expense" means qualified research expense that is incurred for research conducted in Indiana. "Qualified research expense" means qualified research expense (as defined in Section 41(b) of the Internal Revenue Code as in effect on January 1, 2001).

I.R.C. § 41(d) provides:

> Qualified research defined.--For purposes of this section--
> (1) In general.--The term "qualified research" means research--
> (A) with respect to which expenditures may be treated as specified research or experimental expenditures under section 174,
> (B) which is undertaken for the purpose of discovering information--
> (i) which is technological in nature, and
> (ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and
> (C) substantially all of the activities of which constitute elements of a process of experimentation for a purpose described in paragraph (3).

I.R.C. § 41(d) sets out this four-pronged test for verifying qualified research activities. First, the research must have qualified as a business deduction under I.R.C. § 174. I.R.C. 41(d)(1)(A). Second, the research must be undertaken to discover information "which is technological in nature." I.R.C. § 41(d)(1)(B)(i). Third, the taxpayer must intend to use the information to develop a new or improved business component. I.R.C. § 41(d)(1)(B)(ii). Finally, the taxpayer must pursue a "process of experimentation" during substantially all of the research. I.R.C. § 41(d)(1)(C).

2. Documenting the Expenses.

Treas. Reg. § 1.41-4(d) (T.D. 8930) sets out the record keeping and documentation requirement for expenses related to the REC:

> No credit shall be allowed under section 41 with regard to an expenditure relating to a research project unless the taxpayer - (1) Prepares documentation *before or during the early stages of the research project*, that describes the principal questions to be answered and the information the taxpayer seeks to obtain to

> satisfy the requirements of paragraph (a)(3) of this section, and retains that documentation on paper or electronically in the manner prescribed in applicable regulations, revenue rulings, revenue procedures, or other appropriate guidance until such time as taxes may no longer be assessed (except under section 6501(c)(1), (2), or (3)) for any year in which the taxpayer claims to have qualified research expenditures in connection with the research project; and (2) Satisfies section 6001 and regulations there under. (*Emphasis added*).

The Department's audit also considered Treas. Reg. § 1.41-4(d) (TD 9104), the current governing regulation, which states:

> A taxpayer claiming a credit under section 41 must ***retain*** records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit. For the rules governing record retention, see section 1.6001-1. ***(Emphasis added.)***

In turn, Treas. Reg. § 1.6001-1 provides:

> Any person required to file a return of information with respect to income shall ***keep*** such permanent books of accounts or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown in any return of such tax or information. ***(Emphasis added.)***

Indiana also imposes its own general record keeping standard.

> Every person subject to a listed tax must ***keep*** books and records so that the department can determine the amount, if any, of the person's liability for that tax by reviewing those books and records. The records referred to in this subsection include all source documents necessary to determine the tax, including invoices, register tapes, receipts and canceled checks. IC § 6-8.1-5-4(a) ***(Emphasis added)***.

D. Analysis and Conclusions.

In order for its argument to prevail, Taxpayers' activities must meet the four-part test under I.R.C. § 41(d) including the requirement that Taxpayers' activities were undertaken for the "purposes of discovering information" (or "eliminating uncertainty") and must eventually yield a "new or improved business component" each of which derives from a process of experimentation.

As explained by Taxpayers, their businesses develop and produce medical instruments, medical implants, injection molds, and custom workplace platforms. In each case, Taxpayers emphasize the sophistication and precision involved in the development and production of these items. Taxpayers also make much of the fact that their production facilities utilize "cutting edge" waterjet, plasma, and laser technology. However, Taxpayers can point to nothing its businesses have done to discover or eliminate uncertainty and develop a "new or improved business component" incorporated into or necessary to the production of the businesses' products. Not minimizing in any degree, the sophistication of the businesses' products, Taxpayers have pointed to nothing which advances upon or adds to the common knowledge of other similar lines of business. Moreover, Taxpayers have not established that its businesses fundamentally expanded upon the "common knowledge" using variations of long-standing techniques or expanded the "existing level of information in [Taxpayer's] field of science or engineering." Treas. Reg. § 1.41-4(a)(3)(ii).

Taxpayers state their businesses exercise care, expertise, and diligence in producing finished products which specifically meet their customers' needs. Taxpayers conclude that these activities reflect a knowledgeable and detailed process of "trial and error" aimed at improving or differentiating its products. However, the businesses' processes - even if they did lead to the "discovery" of new products - do not necessarily represent "a methodical plan involving a series of trials to test a hypothesis, analyze the data, refine the hypothesis, and retest the hypothesis so that it constitutes experimentation in the scientific sense." *Trinity Industries, Inc. v. U.S.*, 757 F.3d 400, 414 (5th Cir. 2014). As explained by that court, the "process of experimentation" requirement is not met by means of "a method of simple trial and error to validate that a process or product change meets the taxpayer's needs." *Id.* (See also *Union Carbine Corp. and Subsidiaries v. C.I.R.* 97 T.C.M. (CCH) 1207 (Tax Ct. 2009) explaining "It is not sufficient that the taxpayer use a method of simple trial and error to validate that a process or product change meets the taxpayer's needs.")

To be clear on the matter, the Department recognizes the skill, craftsmanship, and diligence which the businesses employ to develop and produce their final products. However, in this case Taxpayers ask for a "summary

judgment-like" resolution of a case which hinges on Taxpayers clearly establishing that their companies spent $2.4 million dollars in doing so and that they are entitled to that credit.

Simply put, Taxpayers make a critical error at the outset because Taxpayers' conflate concepts of difficulty, cutting edge sophistication, and diligence into a nebulous difficulty/sophistication standard which they claim entitles them to the RECs.

The Department is unable to agree that Taxpayers have met their statutory burden under IC § 6-8.1-5-1(c) of establishing that the businesses' activities to develop or improve upon its businesses products constitute "qualified research" activities under either the "Discovery Test" or the "Uncertainty Test." Even under TD 9104, simply demonstrating that "uncertainty" exists in achieving a particular result has been eliminated and that a particular result has been achieved, is insufficient to satisfy the "process of experimentation" requirement. The Department is unable to agree that Taxpayers have established that the businesses' efforts to produce sophisticated medical devices or metal platforms resulted in the discovery of a new product which became part of the body of common knowledge of others skilled in the production of such products.

Setting aside issues related to whether Taxpayers' businesses were engaged in qualified research, Taxpayers disagree with the audit's finding that the businesses failed to adequately document the employees' specific activities and wages attributable to those projects. Taxpayers do not assert that their businesses maintained a system of project accounting in order to accurately quantify the businesses research expenses. Instead, Taxpayers rely on employee surveys, job titles, wage statements, and project descriptions in concluding that the businesses paid their employees approximately $2.4 million dollars to conduct experimentation on components eventually incorporated into or made part of the businesses' products. For example, Taxpayers assert that one of their "mill and lathe" operators "recommended improvements to optimize the design of new parts and tools." As a result, Taxpayers assert that 25 percent of this employee's time was spent in qualifying research activity. Taxpayers state that one of their salespersons "suggest[ed] alternate designs to achieve the project requirements for the specific application." Taxpayers conclude that this salesperson spent 80 percent of his or her time conducting qualifying research. In other words, this salesperson spent 80 percent of his or her time developing a hypothesis, analyzing the experimental data, refining the hypothesis and then incorporating those results into a "component" all of which leads to the expansion of the common knowledge of those skilled in the development of Taxpayers' products. The Department finds such assertions less than convincing and that the bare assertions certainly fall short of the record keeping requirements under federal or Indiana law.

While the Department recognizes Taxpayers' efforts to estimate the qualifying wages of their employees, the Department rejects Taxpayers' argument that the Department is precluded from demanding specific, contemporaneous documentation and that "documentation is not necessary to prove taxpayer engaged in a particular activity in the tax year(s) at issue." Instead, the Department finds the law on this issue clear.

Treas. Reg. § 1.41-4(d) (T.D. 8930) sets out the record keeping and documentation requirement for expenses related to the research credit. In particular, the rule requires that records of qualifying research be prepared "before or during the early stages of the research project," and that these records memorialize the questions to be asked and answered during the course of the experimental research.

The Department rejects Taxpayers' argument that it is sufficient to verify its claim to the credit "based upon whatever alternate means may be available." The Department finds that the argument grossly oversimplifies the relevant regulatory and statutory requirements. Instead, it is Taxpayers' statutory obligation to maintain and produce to the Department contemporaneous records sufficient to verify the credits which they claim pursuant to IC § 6-3.1-4-1 and IC § 6-8.1-5-4. This is especially true in the case of the RECs for which the I.R.C. imposes stringent and detailed parameters and which - if Taxpayers seek to obtain the benefit of those credits - Taxpayers are required to meet. Treas. Reg. § 1.41-4(d) (TD 8930).

Indiana case law speaks in general to the issue of the standard required to establish one's entitlement to credits such as that sought by Taxpayers. "[A]n income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer." *IDOPCP, Inc. v. Comm'r*, 503 U.S. 79, 84 (1992). Moreover, where such a credit is claimed, "the party claiming the same must show a case, by sufficient evidence, which is clearly within the **exact letter of the law**." *RCA Corp.*, 310 N.E.2d at 100-01. **(Emphasis added.)** Thus, every taxpayer's claim against any tax must be supported by records necessary to substantiate the claimed credits and those records are required to be "kept" "before or during the early stages of the research project.

In this case, Taxpayers asks that the Department broadly interpret the REC record keeping requirements to

encompass - as stated in the audit report - "estimated qualified percentage allocations" when there is no evidence that the businesses' efforts to develop and then monitor and control the quality of its products constitutes a "process of experimentation" which led to technological innovations otherwise outside the knowledge of other skilled professionals.

In a Letter of Findings, 01-20181626; 01-20181627; 01-20181628 (August 26, 2020) recently issued, the Department found that a manufacturer of electric power modules and generator enclosures met its burden of establishing that it engaged in qualifying research activities in the development and construction of individual *components*. Moreover, the Department found that the petitioner was entitled to the credit because it had presented its employees' contemporaneously prepared timesheets delineating the extent to which research was conducted on individual components. As explained in the LOF sustaining the petitioner's argument:

> Taxpayer has met its burden of establishing that it engaged in qualified research activities in the development of *components* such as power packages, electrical switchgears, catalytic reduction systems, and environmentally compliant mufflers.

. . . .

> Taxpayer is being sustained because Taxpayer established that it was conducting a methodical, systematic, experimental process by which it developed individual business *components* and, in the process of doing so, expanded the common knowledge of information related to those components.

(*Emphasis added.)*

Moreover, the petitioner provided "contemporaneous" documentation prepared at the "early stage of the research project" tracking the qualifying time each employee spent on each component project.

However, the Department was careful to point out why the petitioner in that case was not being sustained. In part, the August LOF stated:

> • Taxpayer is *not* being sustained, either in whole or in part, because it builds complicated and difficult to construct electrical devices;
> • Taxpayer is *not* being sustained, either in whole or in part, because it has finicky and difficult customers who demand products suited to their particular needs;
> • Taxpayer is *not* being sustained, either in whole or in part, because it faced "uncertainties" in the design and construction of its products;
> • Taxpayer is *not* being sustained, either in whole or in part, because its employees recalled incidents in which they engaged in qualifying activities and were able to tick off the boxes on a survey questionnaire;
> • Taxpayer is *not* being sustained, either in whole or in part, because it repeatedly "explored alternatives" in developing and building its customers' products;
> • Taxpayer is *not* being sustained, either in whole or in part, because it engaged in a simple "process of bare-bones 'trial and error.'"

(*Emphasis in original.)*

On the question of documentation, the August LOF rejected the proposition that any taxpayer was entitled to claim RECs based on "an "employee research and experimentation time allocation questionnaire."

> The Department finds that it is insufficient for a claimant to depend on documentation based solely on interviews with and the recollection of its key personnel, because the assertion oversimplifies the federal and Indiana regulatory requirements.

Further, the Department rejected the similar proposition that it would allow credits based on what the LOF labeled the "take our word for it" standard.

> [T]he Department is asked to allow credits on what is essentially a "take our word for it" (TOWFIT) standard, and although the Department does not question the good faith and veracity of claimants, it does find the TOWFIT standard on which a claimant may rely unworkable, unverifiable, and inconsistent with both the law and common sense. Simply put, Department finds that reliance on the TOWFIT standard is wholly at odds with the Indiana case law which requires that a taxpayer's claim to income tax credits must be established with "sufficient evidence" which is "clearly within the exact letter of the law." *RCA Corp.*, 310 N.E.2d at

100-01.

Are Taxpayers' businesses conducting qualified research and spending good money to do so? Yes, they quite possibly are. Have Taxpayers narrowly defined their activities which lead to the development of individual components which are themselves the results of a "methodical, systematic, experimental process" of experimentation? Have Taxpayers kept and retained contemporaneous documentation of those qualifying activities? As to the last two questions, the Department is unable to agree with Taxpayers that they have done so and done so with the "exact letter of the law." *Id.* Taxpayers have not met the burden of proving the proposed assessment(s) wrong, as required by IC § 6-8.1-5-1(c).

FINDING

Taxpayers' protest is respectfully denied.

October 30, 2020

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An html version of this document.